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SENSITIVE
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DEPARTMENT FOR EUR/CE LAMORE, EB/OMA, INR/EC, TREASURY FOR
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Classified By: Economic Officer Steven Weston for reasons 1.4 (b,d)

¶1. (SBU) Summary. Newly appointed Chairman of Hungary's Financial Supervisory Authority Adam Farkas is moving ahead quickly to reform Hungary's system of financial supervision. In legislation expected to be submitted in September, the independence of the Hungarian Financial Supervisory Authority (HFSA) will be increased, and the agency will be given greater authority, including over macro-prudential regulation. A Constitutional change will be required, however, for the HFSA to have independent authority to issue binding regulations. Most of the other changes can be enacted with a simple parliamentary majority. By assuming responsibility for macro- as well as micro- prudential regulation, the HFSA will need to put aside old rivalries and work more closely with the Hungarian National Bank (MNB). End summary.

¶2. (SBU) As part of the IMF/EU/World Bank financial stabilization package, the GOH committed to strengthening its system of financial supervision. Despite the usual August lull in activity, the GOH is working to prepare legislation to reform the financial supervisory system to correct deficiencies identified by the GOH and international financial institutions. Longstanding and more recently identified deficiencies include:

--The need for greater independence of the Hungarian Financial Supervisory Authority. Under the current structure, the HFSA is a quasi-independent body subordinate to the Ministry of Finance.

--The HFSA lacks independent authority to issue regulations. Currently, the HFSA must rely on the Ministry of Finance to issue regulations relating to supervisory activities.

--Like most countries, the HFSA focuses on micro-prudential issues, and is not empowered to take forward-looking measures to address macro-prudential concerns. For example, although the Hungarian National Bank (MNB) and others issued warnings about the proliferation of foreign currency denominated loans, no entity had the authority to limit the practice.

¶3. (U) At the end of June, the IMF sent a technical assistance team to Hungary to provide advice on possible ways to restructure the system of financial oversight to correct identified deficiencies. The IMF team offered two possible suggestions for restructuring the financial regulatory system. The first would be to incorporate macro-prudential regulation and other functions currently held by the HFSA into the Hungarian Central Bank (MNB), which already has regulation-issuing authority. The alternative suggestion would be to strengthen the existing HFSA by making it more independent and granting it new authorities, including the

ability to issue regulations, while at the same time mandating closer coordination with the MNB on macro-prudential and other issues.

¶4. (SBU) In a meeting on August 6, newly-appointed HFSA Chairman Adam Farkas told U.S. Treasury Representative to Europe Mathew Haarsager that the GOH has decided to follow the second approach in reforming Hungary's financial supervisory system. Farkas noted that his agency was working closely with the Ministry of Finance and MNB in drafting a bill to overhaul the system, which is expected to be presented to Parliament at the beginning of its Fall session in early September. According to Farkas, most of the changes will only require a simple majority to pass in Parliament, and he expects they will pass without much difficulty. In order to grant the HFSA authority to issue regulations, however, a minor change in the Constitution will be required, which would require a two-thirds vote in Parliament. Farkas notes that although this change is nt very controversial, achieving two-thirds support is unlikely, as the opposition will not likely want to be seen as supporting any initiative of the government in the current political environment.

¶5. (C) If, as expected, there is insufficient support to change the Constitution, Farkas noted that one possible solution under discussion is to empower the HFSA to "trigger" a process in which the Ministry of Finance would have to issue a regulation at the request of the HFSA or be required to explain why it refuses to do so. This work-around would remain in place until sufficient support exists in Parliament for the Constitutional change.

COMMENT

¶6. (C) The decision not to fold the HFSA into the national bank appears to have settled the internal debate within the GOH that led to the resignation of former HFSA Chairman Istvan Farkas in June (reftel). A banker with MNB experience, newly appointed HFSA President Adam Farkas (no relation to Istvan Farkas) has been charged with finding a cooperative solution to reforming Hungary's financial supervisory system. With the visit of the IMF team in July, and the expected tabling of reform legislation in September, he seems to be moving quickly to do so. As Deputy Central Bank Governor Julia Kiraly recently pointed out, however, under the chosen solution the HFSA will need to rely heavily on the expertise of the MNB in carrying out new macro-prudential oversight responsibilities. In order to do so effectively, the HFSA, the MNB and the Ministry of Finance will need to put aside rivalries and internal conflicts in order to ensure the close cooperation needed to improve financial supervision in Hungary. End comment.
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